Test: Money

Instructor's Version

Answers: Free-Response Questions

1. Trust plays an important role in complex modern economic systems such as the U.S. economy. You will write about two examples. For each, define the term, describe the role it plays in the economy, and identify the role trust plays.

A. Fiat money (3 points)

Answer:
Fiat money is money that has no intrinsic value. U.S. currency is fiat money, for example, since the currency has value only in its role as money. Fiat money is accepted as payment because it is legal tender; this means the government decrees it should be accepted as money. As long as people have faith that money payments will be accepted by others, they will be willing to accept money as payment. However, when they lose that faith, people will no longer accept fiat money, and it becomes worthless.

1 point for definition of fiat money.
1 point for role as medium of exchange/payment for goods and services.
1 point for issue of trust — traded as long as people believe in its value.

B. Fractional reserve banking (5 points)

Answer:
Fractional reserve banking is a system in which banks hold a portion of deposits in reserve and then loan out the rest of the money. The loan process creates new money. Fractional Reserve banking relies on a couple of beliefs: first, that loans made by banks will be repaid, and second, that a bank's customers won't try to take more than about 10% of their total deposits out of the bank at one time.

2 points for definition of fractional reserve banking.
1 point for something about its role in the economy.
1 point for belief that loans will be repaid.
1 point for no bank runs.

2. The U.S. Federal Reserve is the central bank of the United States. It has many roles in the economy, but one of the key roles is conducting monetary policy.

A. What is monetary policy? (2 points)

Answer:
Increases and decreases in the money supply designed to promote economic health.

1 point for money supply changes.
1 point for economic health.

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B. Suppose the Fed wants to close an inflationary gap. How could it use each of the three tools of monetary policy to close the gap? (6 points)

Answer:
Open market operations: The Fed could sell T-bonds to take money out of the economy.
Discount rate: The Fed could increase the interest rate it charges on discount window loans.
Required reserve ratio: The Fed could increase the percentage of deposits a bank is required to hold in reserve.

1 point for each tool.
1 point for each use of the tool.

C. Using the monetary policy tool the Fed employs most often, the Fed closes an inflationary gap. Describe the steps the economy goes through to move to the new equilibrium output and price level. ***Use graphs with your answer and be sure to label everything completely.*** (6 points)

Answer:
Graph shows the decrease in the money supply brought about by Fed sales of bonds, which results in a higher interest rate. Graph can be either money market, with vertical money supply curve shifting left, or bond market with supply curve for bonds shifting left. As a result, the interest rate increases.
This decreases investment (student may or may not show investment demand graph).
This decreases aggregate demand, which is shown on an *AD/AS* graph. This also reduces equilibrium RGDP and equilibrium price level.

1 point for recognizing that the Fed is using OMO.
1 point for graph of money market or bond market.
1 point for increased interest rate.
1 point for decreased investment (with or without graph).
1 point for AD/AS graph with decreased AD curve. This point is missed if they use AE graph, since that graph won't show the change in the price level.
1 point for decrease in RGDP and decrease in price level.

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3. There is debate concerning both monetary and fiscal policy. You'll examine each separately, then together.

A. Below are two arguments against using fiscal policy. Explain each.

I. Permanent income hypothesis. (3 points)

Answer:
According the PIH, people spread income over their lifetime. This means temporary changes in income tend to be saved rather than spent. Since the fiscal policy multiplier effect depends on the size of the marginal propensity to consume, if people are saving rather than spending additional income, the multiplier effect will be smaller, so fiscal policy will be ineffective. Therefore, monetary policy is preferred.

2 points for spreading income over time.
1 point for smaller multiplier effect on fiscal policy.

II. Effects of a dollar of government spending versus a dollar of private spending. (3 points)

Answer:
The argument is that when the government spends money, it takes resources away from the private sector. If you believe that a dollar of private spending has a greater effect on the economy in terms of current income and long-term growth, you'll want the government to spend less and put more money into the hands of business. This means government spending should be minimized, though tax cuts to promote growth are a good idea.

1 point for idea that government spending takes resources from private firms.
1 point for the idea that private spending might have a stronger effect than government spending.
1 point for identifying that this argues against fiscal spending policies, but not against fiscal policy that lowers taxes.

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B. The main argument against monetary policy is that it affects only nominal variables, not real variables. Explain this argument using the two methods below.

I. Explain and show on a graph the short-run and long-run equilibrium changes in the *AD/AS* model from expansionary monetary policy. How does this support an anti-monetary policy stance? (5 points)

Answer:
The graph will have an upward-sloping short-run AS curve, with the long-run AS curve a vertical line at full employment. An increase in AD from an expansionary monetary policy will increase RGDP in the short run, but in the long run the economy will return to full employment through a decrease in aggregate supply. Eventually, the monetary policy results in a higher price level but fixed RGDP — the nominal variable changes but the real variable doesn't.
If you believe the adjustment to long run occurs quickly, you won't be in favor of monetary policy.

1 point for graph showing increase in AD.
1 point for showing short-run and long-run AS curves.
1 point for showing long-run adjustment.
1 point for indicating the nominal versus real variables.
1 point for quick adjustment being contrary to monetary policy.

II. Explain the equation of exchange. What do quantity theorists believe, and why don't they support monetary policy? (3 points)

Answer:
The equation of exchange says $MV = PQ$. Quantity theorists believe Q is fixed at full employment, and V is steady, so a change in M only changes P. This means monetary policy doesn't affect the real variable Q, the quantity of output, but affects only the nominal variable P, the price level.

1 point for showing equation of exchange.
1 point for belief that Q is fixed and V is steady.
1 point for changes in M change only P and not Q or V.

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C. Some people will argue against using either monetary or fiscal policy, instead supporting a laissez-faire approach to the economy. The well-known economist Milton Friedman, for example, believed in the permanent income hypothesis and was also a monetarist. What monetary policy prescription do monetarists support? (2 points)

Answer:
Monetarists believe the Fed should choose a rate of growth for the money supply and then stick to that regardless of the state of the economy.

1 point for fixed money supply growth.
1 point for no discretionary changes in the money supply.

(These ideas are similar, so one statement may capture both ideas. Instead of looking for each, look for contradictions for either, and deduct the point they missed.)

D. The Phillips curve shows an important tradeoff faced by economic policymakers. This tradeoff was used to point out the legitimacy of government intervention in the economy for many years.

I. What is the Phillips curve? What does it show? Why is it important to economic policymakers? (3 points)

Answer:
The Phillips curve shows the tradeoff between inflation and unemployment. In the short run, inflation can be decreased only if unemployment is increased, and vice versa. This tradeoff is important for policymakers to identify, so they don't blindly follow a low inflation policy, for example, resulting in high unemployment.

1 point for inflation and unemployment.
1 point for tradeoff.
1 point for importance (anything intelligent is fine).

II. The tradeoff demonstrated by the Phillips curve seemed to fail during the 1970s. Why? What happened? (2 points)

Answer:
High unemployment coupled with high inflation as a result of the oil shocks caused stagflation.

2 points for stagflation, either by name or description.

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III. What is the currently accepted belief about the Phillips curve?
Hint: This question has to do with the long run versus the short run. (2 points)

Answer:
There's a short-run tradeoff between inflation and unemployment, so the original curve describes the short-run trade off. However, in the long run the Phillips curve is vertical at the natural rate of unemployment.

1 point for short-run tradeoff.
1 point for vertical long-run PC at the natural rate of unemployment.

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